VII. Cigarette Smuggling

Varying State Rates Provide Motive

Since 1965 cigarette bootlegging (or "buttlegging") has become a serious problem for a number of states in the area of tax administration and law enforcement. This is due primarily to the growing profit incentive provided by the ever-increasing disparities in many States' cigarette tax rates. Tax rates now range 2 or 3 cents per pack in North Carolina, Virginia, and Kentucky and from 12 cents to $1.00 cents per pack in other States. This can create a difference in price of up to $10.00 per carton and, hence, the profit motive for cigarette bootlegging. At the same time this variation in tax rates provides a source of revenue to organized crime.

Public discussion of the cigarette smuggling problem has traditionally focused on the abstract question of state revenue losses and has failed to address the associated social costs of cigarette smuggling.

High-tax states lose needed tax revenues which support vital public services. Additionally, the legitimate cigarette industry is adversely impacted by organized smuggled activities. The infiltration of organized crime has brought extortion and bribery, truck hijackings, armed robberies, serious assaults, and even murder.

Until 1978 the only Federal statute which directly related to the interstate shipment of cigarettes was the Jenkins Act (15 U.S.C. sec. 375 et. seq.). The Jenkins Act applies primarily to cigarette distributors who send their cigarettes through the mails to customers in other States. It has limited usefulness for attacking the over-the-road "bootlegging" or smuggling operation in which the purchaser transports the cigarettes out of the state of purchase and secretly brings them into another State for resale.

Public Law 95-575

As a result of increasing revenue losses being incurred by States with high cigarette tax rates, the U.S. Congress approved Public Law 95-575 on November 2, 1978. The Secretary of the Treasury was delegated the responsibility for the law's enforcement, codified as Title 18 U.S.C., Chapter 114. However, it should be emphasized that Congress explicitly stated its intent that primary responsibility for cigarette tax enforcement lay at the State level, with the Federal effort to be concentrated in those areas beyond the jurisdictional and resource capabilities of the States.

The law prohibits the transportation, receipt, shipment, possession, distribution or purchase of more than 60,000 cigarettes not bearing the required tax indication of the State in which they are found. Tobacco manufacturers, tobacco exporters, common carriers transporting cigarettes under bills of lading, and State licensed "stamping" agents are exempt under this statute. Violation of the statute is punishable by imprisonment for a term not to exceed five years and/or a fine of up to $100,000. Conveyances used to transport contraband cigarettes are subject to seizure.

The law also authorizes the Secretary of the Treasury to issue regulations requiring that persons engaged in transactions involving more than 60,000 cigarettes maintain disposition records to show the name, address, destination, vehicle license number, driver's license number, and signature of the purchaser as well as a statement of the purpose of the purchase and the identity of the principal recipient if the purchaser is acting as an agent. Falsification of the required disposition records is punishable by imprisonment not to exceed three years and/or a fine not to exceed $5,000.

The figure of 60,000 cigarettes was arrived at after Conference Committee deliberations to reconcile differing versions of the law. The House bill had set the proscribed level at 30,000. The Conference Committee agreed on the 60,000 figure in order to concentrate the Federal enforcement effort at a level well above that of the "casual" or occasional smuggler or traveler purchasing cigarettes in low tax States for personal consumption. This intention was further supplemented by including cigarette smuggling within the umbrella of the Racketeer Influenced Corrupt Organizations (RICO) statute.

ATF Inspection Protocol

On September 19, 1980, the cigarette smuggling regulations became effective. Prior to this date ATF had no authority to conduct any inspections of dealer records. Most states do have such authority and ATF worked with State agencies in the conduct of audits or record checks of wholesaler/stamping agents and retail outlets within their jurisdictions. After September 19, 1980, in order for ATF to check any records of a wholesaler, etc., ATF must obtain their permission, an administrative inspection warrant or a search warrant (27 CFR 296.153(a)). This is necessary, since the law does not allow for open inspection of records. Consent or a judicial order is needed to examine the required disposition records and such inspections are limited only to those records specified under the law and its implementing regulations.

Perhaps as a result of this increased law enforcement effort, occurred in the early 1980's a decline in revenue losses and a lessening of cigarette smuggling. However, the problem remains significant. As noted earlier, it has both in recent years (1994-1997) a resurgent in trafficking has increased and casual and organized criminal components. Casual smugglers include commuters, truckers, salesmen, tourists, and individuals living close to a state/city/county/boundary where a tax disparity exists. Retail outlets generally are numerous on major tourist routes and close to the boundary in low tax jurisdictions. Enforcement efforts have determined that tax disparities as small as $.05 per pack can contribute to a potential smuggling problem.

Methods of Tax Evasion

The normal cigarette distribution system provides both casual and organized smugglers considerable opportunity to evade state taxes. Enforcement efforts are frequently constrained by shortages of trained state personnel. While there is some degree of overlap, **four major ways** that cigarettes are diverted or purchased with a lower tax or no tax can be identified:

- Over-the-road smuggling
- Tax-exempt sales
- Theft
- Illicit operations by state licensed stamping agents

Over-the-Road Smuggling

"Over-the-road" includes both organized criminal activity and casual smuggling. Casual smuggling by out-of-state travelers passing through low tax States is a long-standing tradition. In 1978, for example, approximately 6.5 million cartons were sold in North Carolina along route I-95 to out-of-state purchasers. Purchases of this type are generally for well under 100 cartons per transaction and are likely to continue as long as the carton prices vary significantly from state to state. In the past, organized crime has sometimes used the same wholesale/retail outlets as the casual smuggler; however, the size of the purchase is considerably greater.

Although organized smuggling operations have used a wide variety of ways to transport the cigarettes, because of the volume required to produce a lucrative return, rental vehicles are most common. While casual and organized over-the-road smuggling has been seriously affected by factors such as increased enforcement efforts "traditional" patterns are expected to continue.

Tax-Exempt Sales

The diversion of tax-free cigarettes is almost as traditional as over-the-road smuggling and has casual and organized facets. There are three major sources of non-taxpaid cigarettes: export cigarettes, and cigarettes sold on Indian and military reservations. Unlike cigarettes from the other two sources, no Federal or State taxes have been paid on cigarettes intended for exportation. These cigarettes can therefore be diverted into domestic smuggling activities and illicit sales even more “profitable”.

Illicit tax-free Indian sales are more common. Most states with Indian reservations have identified revenue losses. While Indian sales to Indians are exempt from State taxes, sales by Indians to non-Indians are not, at least as far as the respective States are concerned. Some States have attempted to resolve the problem by requiring that the State tax be pre-paid, with a subsequent refund if the sale is made to an Indian. This controversy has raised numerous jurisdictional questions and resulted in several U.S. Supreme Court cases. The most recent Supreme Court case rendered the decision the Federally recognized Indian Tribes enjoy Tribal sovereign immunity from State taxation on sales of goods to tribal members that occur on reservation or trust lands, but not on such sales to non-tribal members.

Sales to non-tribal members would thus appear to be taxable by the States. However, the actual decision did leave *many* enforcement questions unanswered.

Illicit Stamping

Finally, ATF investigations have identified potential major sources of revenue loss to the various states through such practices as counterfeit stamping operations and manipulation of interstate cigarette distribution reports. These reports, in varying formats, are used by states to verify interstate shipments of cigarettes by interstate stamping agents. Most states do allow out-of-state tax stamping for their state; e.g., distributors or stamping agents in New Jersey stamp for New York. Without an accounting system and an audit/inspection program, New Jersey or New York tax officials would not know that a firm actually paid the New York State tax on cigarettes destined for New York. The cigarettes also could be distributed illicitly in New Jersey without the New Jersey tax being paid.

These activities are characteristic of the larger and more sophisticated criminal operations, possibly involving collusion between certain wholesalers and firms with outlets such as vending machines, stores, etc. This type of criminal activity appears to be widespread, represents the bulk of organized criminal involvement, and accounts for major state revenue losses.

Current Focus of ATF’s Tobacco Regulation

Due to an escalation in cigarette trafficking, ATF’s cigarette smuggling program has been somewhat re-emphasized. Most activity is centered on providing assistance to the states, and reacting to specific information. ATF also has become involved in the prosecution of violators under Public Law 95-575. The future of ATF enforcement efforts depends upon both budgetary allocations and the level of criminal activity by cigarette smugglers.